



California Tax Reform Association

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January 19, 2007

To: Member of the Air Resources Board Climate Action Team

From: Lenny Goldberg, California Tax Reform Association

Re: Carbon permit fee/auction: request for agenda item and public discussion

The California Tax Reform Association respectfully requests that the ARB place on an upcoming agenda an extensive public discussion of section 38597 of AB 32. That section grants the ARB authority to enact a carbon permit fee “for the purposes of carrying out this division.” The “division”, of course, is the entire program, and the implementation of a carbon fee is the single most important step you can take to reduce carbon emissions.

The lack of public discussion of this aspect of AB 32 has been disappointing. Not only is a fee or a public auction the key to creating a functioning emissions market, but the revenues generated will help California take a quantum leap toward leading the world in carbon emission reductions.

This issue is particularly critical in any discussion of a cap and trade system, where the key question is whether the market works better in achieving carbon emission reductions if credits are auctioned or given away for free. In our view, to ask the question is almost to answer it, but all views should be welcome in this debate. Thus, we request that a part of the ARB’s efforts, which include not only official agendas but also a series of public presentations, be directed toward the resolving this question.

Then a series of interesting questions arise, which surely should be under discussion as well, including the appropriate design of an auction, the mechanisms necessary for monitoring and enforcement, and, of course, in conjunction with the Legislature, what the estimated \$2.5 billion should be used for. We are confident that if a fully articulated discussion takes place, the overwhelming advantage of paying for permits to pollute will be apparent to all.

The use of a fee or tax, whether by a direct levy or through an auction, of carbon permits, is acknowledged by virtually all economists to be the most efficient and effective of market-based incentives for reducing carbon emissions. The economics of this issue are basic and, we think, irrefutable:

- carbon emissions impose costs on society which are not captured in the market. Hence, the need for a fee to internalize the external costs and make carbon emissions part of the cost of doing business or driving a car.
- making emitters pay for carbon emissions immediately gives them (us) the incentive to seek lower emissions, in whatever form they (we) choose.
- revenue generated from payments for carbon permits has multiple important uses: mitigating the costs of transition for certain sectors or for the poor; subsidies for effective emission reductions, research and new technologies; more generally, smoothing and enhancing the transition to an economy based on the use of fewer fossil fuels.

- markets work when something of value is traded. In a cap and trade system, flooding the market with free carbon credits is far less effective than auctioning permits and establishing a true market-clearing price.

A carbon fee stems from the work of A.C. Pigou, an early 20th century economist who developed the externality concept, observing that the market fails to capture the costs of pollution. A “Pigovian” tax would tax pollution and therefore alter relative prices to provide incentives to reduce emissions, to the optimal point where it can be done at maximum efficiency.

This type of tax or fee is favored particularly by conservative economists as a market-based alternative to direct regulation.¹ But it works as well in a regulatory context, particularly where emissions are capped and the appropriate market price is determined by auctioning of carbon permits. A Pigovian tax has a “double dividend”, such that not only is pollution lowered by the tax, but the revenues can be used for subsidies where market prices do not reflect the benefits of activities which lower emissions.

In the California context, the auction is considered a fee, not a tax, since the proceeds of the permits are used for the directly related purposes of the program itself. Section 38597 states, “The state board may adopt by regulation, after a public workshop, a schedule of fees to be paid by the sources of greenhouse gas emissions regulated pursuant to this division...” While the fee itself can clearly be enacted by the ARB on its own motion, AB 32 calls for the funds to be appropriated by the Legislature. At this point, our suggestion is only to start the process of a public workshop as called for in the legislation.

With the fee in place, the ARB and the Legislature can engage in highly productive debate over the best ways of deploying those funds for the purposes of reducing carbon emissions or mitigating impacts. There will be no shortage of opportunities, from subsidizing public transit to supporting research and commercialization of new technologies to an earned income tax credit to mitigate the effects on the poor.

With regard to the advantages of using an auction to create a cap-and-trade market, we do not claim particular expertise in market design but refer you to the experience of Europe, as described in the Economist,² where the flooding of the market led to the collapse of prices—hardly reassuring to market participants. In our view grandfathering rewards those who already pollute with a property right to continue, encourages gaming, limits incentives to change behavior, and, as noted, seems not to have worked. Again, a public discussion among economists should be part of your immediate workplan. We expect the results will be overwhelmingly in favor of an auction, but perhaps there are reasons—e.g. doing this in one state alone—which might give pause.

One question for discussion is whether such a fee should begin immediately. The carbon content of electricity production, transportation fuels, and major manufacturing is known. For transportation fuels, the fee can easily be collected at the refinery or wholesale level, based on the ultimate carbon output of the gasoline, diesel, and jet fuel shipped. The Public Utilities Commission has sufficient data about the composition and production of the electricity portfolio, such that the output of each plant can be permitted and charged, so that relative prices of long-term contracts can be more accurately determined and the relative price of non-fossil generation is improved. Local Air Boards

¹ “Economic View: Raise the gas tax? Funny, it doesn’t sound Republican,” New York Times, October 8, 2006

² “Terminating Greenhouse Gases: What Europe’s Failing Effort to cut Carbon Emissions can Teach California,” the Economist, October 19, 2006

should have sufficient data on major manufacturers which burn fossil fuel, and the carbon content of emissions, such that the appropriate levels of permits can be sold.

While additional work needs to be done on the mechanics of an auction in the context of a cap on emissions, Redefining Progress has suggested an initial permit fee of \$20 per ton of carbon, which would generate approximately \$2.5 billion. That's only a first estimate, but undoubtedly the benefits and revenues are substantial. RP's analysis clearly demonstrates that such charges are beneficial, not detrimental, to the business climate.

We appreciate the concerns that may arise about doing this in only one state. It is notable that on January 18, last Thursday, Massachusetts passed a system of auctioning permits. One benefit of charging for the permits is that costs can be directly mitigated in California from revenues raised, and California will reap a tremendous advantage by investments in cutting edge technology. Clearly, we can find highly advantageous ways to recycle the \$2.5 billion back into the economy in ways that foster growth with far fewer carbon emissions.

In short, the ARB has a tremendous opportunity to get the system right, learning from the mistakes which have already occurred in other markets and other environments, most notably Europe. At minimum, we urge you to recognize the explicit authority you have, and begin the debate. We have no doubt that an honest, open debate on this critical subject will lead to the right answer. And California will truly be in the lead—or, at least, second to Massachusetts—with regard to dealing with global warming.